

Franchise Tax Board**ANALYSIS OF AMENDED BILL**

Author: Dymally Analyst: Jennifer Bettencourt Bill Number: AB 71
Related Bills: See Legislative History Telephone: 845-5163 Amended Date: April 9, 2007
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Employer Provided Health Insurance Credit/Small Business Health Care Tax Credit Act

SUMMARY

This bill would create a tax credit for certain small business taxpayers that provide health insurance for their employees.

SUMMARY OF AMENDMENTS

The April 9, 2007, amendments removed provisions related to an annual automatic adjustment of the minimum wage, and added the Small Business Health Care Tax Credit Act provisions.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

It appears the purpose of this bill is to encourage small business employers to begin providing affordable health insurance to their employees.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2007.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Amendments 1 through 4 have been provided to correct technical errors and clarify language.

Board Position:

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Department Director**Date**

Lynette Iwafuchi

5/21/07

For Selvi Stanislaus

ANALYSIS

FEDERAL/STATE LAW

Current federal and state law does not provide a tax credit for health care costs.

Current federal law allows ordinary and necessary business expenses to be deducted, including health care coverage premiums paid by an employer for accident or health plans for employees and allows self-employed persons to deduct from gross income 100% of amounts paid for health insurance for themselves, spouses, and dependents. California law conforms to both of these provisions.

Under current federal law, the amount of an employer's contribution, including any salary reduction contribution made through a cafeteria plan, to an accident or health plan for the benefit of an employee or the employee's spouse or dependents, is excluded from the employee's gross income. California law also conforms to this provision.

For tax years beginning on or after January 1, 1997, California conformed to the federal provisions that allow an individual to deduct contributions to an Archer Medical Savings Account (MSA); however, California does not conform to any of the federal Health Savings Account (HSA) provisions, including the tax-free rollover from an MSA to an HSA.

THIS BILL

This bill would allow a credit equal to the percentage of the amount paid by a qualified small employer for qualified employee health insurance expenses. The following would be the applicable percentage:

- 50% for an employer with less than 10 qualified employees
- 25% for an employer with more than 9, but less than 25 qualified employees
- 20% for an employer with more than 24, but less than 50 qualified employees

This bill would limit the amount of qualified employee health insurance expenses as follows:

- Cannot exceed \$4,000 for self-only coverage
- Cannot exceed \$10,000 for family coverage

This bill defines the following terms:

“Qualified small employer” means any small employer who provides eligibility for health insurance coverage after any waiting period¹ to all qualified employees, and pays at least 50% of the cost of that coverage for each employee.

¹ Defined in IRC section 9801(b)(4) as the period that must pass with respect to the individual (who is a potential participant or beneficiary) before the individual is eligible to be covered for benefits under the terms of the group health plan.

“Small employer” means, for any taxable year, any employer with aggregate gross assets during the preceding three taxable years that do not exceed \$5 million, and employs an average of more than one but less than 50 qualified employees on business days during the preceding taxable year.

With regard to business conducted during the preceding taxable year, this bill requires that both of the following should apply:

- A preceding taxable year must be used only if the person operated as an employer throughout that year.
- If the person did not operate as an employer during the preceding taxable year, then the average number of employees that is reasonably expected to be employed on business days in the current taxable year is to be determined.

“Aggregate gross assets” is defined by reference to section 1202(d)(2) of the Internal Revenue Code (IRC), which in general means the amount of cash and fair market value of other property held by the corporation.

“Qualified employee health insurance expenses” means any amount paid by an employer for health insurance coverage for a qualified employee. No amount paid or incurred for health insurance coverage that results in a salary reduction would be allowed as an expense.

“Health insurance coverage” has the meaning given that term by IRC section 9832(b)(1) and is generally defined as benefits consisting of medical care provided directly through insurance, reimbursement, or otherwise. Medical care must be provided under any hospital or medical service policy, certificate, or service plan contract, or health maintenance organization contract offered by a health insurance issuer. Certain excepted benefits² would not be treated as medical care.

“Qualified employee” means an employee of a qualified small employer who is not provided health insurance coverage under any of the following:

- Health plan of the employee’s spouse
- Social Security Act titles:
 - XVII, relating to health insurance for aged and disabled individuals
 - XIX, relating to grants to states for medical assistance programs
 - XXI, relating to state children’s health insurance programs
- United States Code:
 - Title 38, Chapter 17, relating to veteran’s benefits for hospital and nursing home medical care
 - Title 10, Chapter 55, relating to medical and dental care for members of the armed forces
 - Title 5, Chapter 89, relating to health insurance for government organizations and employees

² Excepted benefits generally include insurance coverage for accident, disability or any supplement to liability insurance, workers compensation, automobile medical payment, credit-only, coverage for on-site medical clinics, and any other secondary or incidental insurance.

- Any other law

“Employee” is defined as follows:

- Any individual who is expected to receive no more than \$50,000³ of compensation from the qualified small employer during any calendar year.
- Does not include an employee as defined in IRC section 401(c)(1) as a self-employed individual.
- A leased employee within the meaning in IRC section 414(n), which provides that a leased employee is treated as an employee of the recipient for purposes of providing benefits or contributions.

“Compensation” means amounts described in IRC section 6051(a)(3), which refers to the total amount of wages relating to services performed by an employee.

This bill provides that the Franchise Tax Board (FTB) may prescribe rules and regulations that provide references in the treatment of a small employer, including references to predecessors of the small employer.

This bill would disallow the credit for a qualified small employer for any period, unless at all times during that period health insurance coverage is available to all qualified employees of the employer for any period under similar terms.

In addition, this bill specifies that no deduction or credit under any other provision would be allowed with respect to the qualified employee health insurance expenses taken into account for this credit. Any excess of the credit would be carried over until it is exhausted.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

- This bill requires that a “qualified small employer” provide eligibility for health insurance coverage, after any waiting period as defined in IRC section 9801(b)(4), for all qualified employees. The term “provide eligibility” is unclear, and the referenced IRC section does not indicate how long the waiting period should be or if an employer is required to give a waiting period. As a result, the department would be required to verify that a waiting period was provided under the employer’s health plan.
- This bill specifies that FTB may prescribe rules and regulations regarding the treatment of a small employer, yet is unclear on the purpose of the rules and regulations and what they would reference. The author may wish to amend the bill to clarify this requirement.
- This bill would disallow the credit for “any period” unless at all times during that “period” health insurance coverage is available to all qualified employees. It is unclear what “any

³ This bill would require the \$50,000 to be adjusted each calendar year beginning on January 1, 2008, by the federal cost of living adjustment determined under IRC section 1(f)(3), rounded down to the nearest \$1,000.

period” would include. This language is confusing and could complicate the administration of this credit. As such, the author may wish to amend the bill to clarify this language.

- This bill limits the amount of health insurance expenses for any taxable year to no more than \$4,000 for self-coverage and \$10,000 for family coverage. It is unclear if this limits the amount of the credit or if the employer’s costs cannot exceed these amounts for each qualified employee. The author may wish to amend the bill to clarify how the limitation would apply when figuring the credit.
- The computation of the number of employees that determines whether the employer is a “small employer” needs to be clarified. For example, would the requirement of 50 employees include part time equivalents or only include full time, 40-hour week employees, or would it be determined by an average number of employees within a given time period? Clarification would assist the department to administer the provisions of the bill as the author intends.
- The term “business days” is undefined. The absence of definitions to clarify terms could lead to disputes with taxpayers and would complicate the administration of this credit.

TECHNICAL CONSIDERATIONS

Non-substantive technical errors are noted. It is recommended that these changes be made to make the language of the bill grammatically correct. Suggested amendments have been provided to correct technical errors.

LEGISLATIVE HISTORY

AB 85 (Nakanishi, 2007/2008) and SB 199 (Harman, 2007/2008) would allow a 15% credit for amounts paid or incurred during the taxable year by a qualified taxpayer that provides qualified health insurance for its employees who perform services in California. These bills are currently in the Assembly Revenue and Taxation Committee.

SB 151 (Denham, 2007/2008) would allow a credit equal to the amount paid or incurred by a qualified employer during the taxable year for qualified health expenses. This bill is currently in the Senate Revenue and Taxation Committee.

SB 2737 (Nakanishi), SB 1639 (Dutton), and SB 195 (Maldonado), from the 2005/2006 legislative session, were similar to this bill. These bills failed to pass out of the house of origin.

AB 1262 (Campbell), AB 1734 (Thomson), and AB 2765 (Knox) from the 1999/2000 legislative sessions and AB 39 (Thomson/Campbell) and AB 694 (Corbett) from the 2001/2002 sessions would have created an employer provided health insurance credit. These bills failed passage in the Assembly.

SB 2260 (Stats. 1988, Ch. 1521) would have provided a small-employer health coverage tax credit; however, that credit was repealed before becoming operative.

OTHER STATES’ INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide a credit comparable to the credit allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California’s income tax laws.

FISCAL IMPACT

The present personal income tax forms have limited space available for additional lines. If the changes required by this bill increase the forms from two to three pages, the department would incur costs of over \$2 million for revising the forms and instructions, printing, systems changes, processing, and storage. This bill would require changes to department systems, forms, and processes. An estimate of the fiscal impact to the department to implement this bill will be developed as the bill progresses through the legislative process.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill is estimated to be as follows:

Revenue Impact of AB 71 Enactment Assumed After June 30, 2007			
	2007-08	2008-09	2009-10
Revenue Impact	-\$550 million	-\$850 million	-\$1.15 billion

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Using industry data, it is estimated that approximately 2,700,000 employees will work for qualified employers in 2007. Of these, about 700,000¹ receive insurance for themselves and 300,000² for themselves and family. Based on a survey of literature, the annual health maintenance organization cost was assumed to be \$4,000 for employee only and \$10,000 for employee and dependents. An annual growth rate of 8% was assumed for these healthcare costs. Assuming employers pay 85% of the insurance costs for employees and 75% of costs for employees and dependents, approximately \$4.6 billion of qualified healthcare costs for 2007 would be paid by employers:

	Total Number of Employees*	Average Premium	Employers Cost	Total Employer Cost
Self Coverage	700,000 ¹	\$4,000	85%	\$2.4 billion
Family Coverage	300,000 ²	\$10,000	75%	\$2.2 billion
Total Employer Cost for Premiums				\$4.6 billion

* Number of employees currently receiving health care benefits.

Under current law, employers are entitled to deduct these expenses. It is assumed that 90% of this amount would be apportioned to California, and 75% of the credit amount would be absorbed by sufficient tax liability. Assuming a tax rate of 7.5% would result in approximately \$230 million

$(\$4.6 \text{ billion} \times 0.90 \times 0.75 \times 0.075 = \$230 \text{ million})$ in deductions that would no longer be taken under this bill.

Assuming a 10% increase as a result of this bill, the total qualified healthcare cost would increase to approximately \$5 billion ($\$4.6 \text{ billion} \times .10$). Applying the three different credit percentages that would be allowed under this bill to an average number of qualified employers, would result in approximately \$1.65 billion in qualifying credits. We assume that only 75% of \$1.65 billion would be claimed as credit due to sufficient tax liabilities and 67% of this amount due to such factors as other credits and net operating loss carryovers. This results in approximately \$820 million ($\$1.65 \text{ billion} \times 0.75 \times 0.67 = \820 million) in potential credits

Taking into account the offsetting deductions results in a tax revenue impact of approximately \$590 million ($\$230 \text{ million} - \$820 \text{ million} = \590 million loss).

Collected data indicates that 10% of employers have gross asset values exceeding \$5 million. Eliminating these employers would result in a revenue impact of \$530 million ($\$590 \text{ million} \times 0.90 = \530 million) for 2007.

The numbers in the table above are net of deductions and have been adjusted to reflect cash flow estimates for fiscal years.

ARGUMENTS/POLICY CONCERNS

This bill utilizes IRC section 1(f)(3) to determine the annual cost of living adjustment (COLA) applicable to the "compensation" limitation. The author may wish to amend the bill to instead refer to the California COLA, as this adjustment may more accurately reflect the California economy versus the national economy. The department currently uses a California COLA to adjust other limitations in the Revenue and Taxation Code.

This bill would use the preceding taxable year information to define a "small employer." Because the credit is not actually claimed until the taxable year has closed, the actual employment experience will be known while the tax return is being prepared. Therefore, the current taxable year would be a more efficient way to determine if an employer meets the "small employer" qualifications.

This bill would allow for an unlimited carryover period. Consequently, the department would be required to retain the carryover on the tax forms indefinitely. Recent credits have been enacted with a carryover period limitation because experience shows credits typically are exhausted within eight years of being earned.

This bill does not restrict the credit to employers with employees who perform services within California (and are thus themselves subject to California tax on their earnings), so that California may be subsidizing employers with many, if not most, of their employees outside of California. However, addition of such a requirement may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 71
As Amended April 9, 2007

AMENDMENT 1

On page 3, line 10, strikeout "both", and insert:
"either"

AMENDMENT 2

On page 4, line 16, after "or", and insert:
"after"

AMENDMENT 3

On page 7, line 34, strikeout "this", and insert:
"the"

AMENDMENT 4

On page 5, line 38, strikeout "both", and insert:
"either"